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IN THE

Supreme Court of the United States

October Term, 1992

TXO PRODUCTION CORP.,

Petitioner,

v.

ALLIANCE RESOURCES CORP., TUG FORK LAND COMPANY, GEORGE KING, AND GROVER C. GOODE,

Respondents.

ON WRIT OF CERTIORARI TO THE
SUPREME COURT OF APPEALS OF WEST VIRGINIA

[illegible] WEST VIRGINIA TRIAL LAWYERS [illegible] IN SUPPORT OF RESPONDENTS

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[illegible] Law

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INTEREST OF *AMICUS*

With the written consent of the parties, reflected in letters filed with the Clerk pursuant to Rule 37, the West Virginia Trial Lawyers Association submits this brief as *amicus curiae*.

The members of the West Virginia Trial Lawyers Association are aware first-hand of the critical role punitive damages play in advancing important state policies, in West Virginia and elsewhere. Represented here by law professors who have published important "law and economics" articles analyzing punitive damages, the members of the Association are familiar with the legal foundation of such damages, especially the deterrence rationale articulated by Justice Richard Neely of the West Virginia Supreme Court in the decision below.

Petitioner TXO Production Corp. has mischaracterized the deterrence rationale underlying the award of punitive damages in this case. That rationale does not predict that in all cases "optimal" deterrence will be achieved simply by requiring a defendant to pay a plaintiff's out-of-pocket losses. To the contrary, the determination of optimal deterrence requires consideration of three principal factors: (1) the magnitude of the wrongdoer's expected gain; (2) the social cost of the kind of activity in which the wrongdoer has engaged; and (3) the probability that the wrongdoer might escape detection or punishment. Merely making a plaintiff whole *ex post*, as TXO proposes to do, will produce underdeterrence in some, if not many, cases for reasons discussed further herein.

In particular, a defendant like TXO that engages in conduct likely to produce both large private profit and great social cost, but whose attempt to implement its scheme and realize its anticipated gain fails because of the vigilance of the intended victim, should not be permitted to limit its damages to the meager out-of-pocket costs expended by the victim in the course of the latter's preventive action. Such a limitation would be truly perverse, as it would allow an intentional tortfeasor to realize large profits if its scheme succeeded and to pay only minimal damages if its plan was thwarted — a judicial version of "heads I win, tails you lose." An arsonist whose plans are foiled by the actions of a quick-thinking homeowner in dousing the flames should not have her punishment limited to the cost of a new fire extinguisher.

SUMMARY OF THE ARGUMENT

The argument in TXO's brief regarding "rational" or "optimal" deterrence contains a number of basic economic mistakes. In particular, the following claims are inaccurate or accurate only under certain specialized conditions not disclosed in TXO's brief and, more importantly, not present in this case:

- TXO contends that punitive damages are needed only to account for the probability that wrongdoing will go undetected and that, "[i]f every tort were detected and penalized, no punitive award would be necessary to further the State's deterrence goal." Brief of Petitioner ("Pet. Br.") 28-29.
- TXO maintains that a defendant's gain can be no more than a plaintiff's loss, and that, "[a]ccordingly, assessing a damage award that fully recovers the actual harm to the party whose title has been slandered would have the effect of removing *all* gains from the wrongful activity, effectively deterring that activity." Pet. Br. 28.
- TXO asserts that "there are substantial social costs associated with overdeterrence" of intentional torts, and therefore "a rational application of deterrence theory produces a punitive award just sufficient to persuade individuals not to engage in activity that the State condemns." Pet. Br. 28 & n.26.

Each of these propositions is fallacious or, at minimum, quite misleading as stated. Although *amicus* does not argue that the Constitution enshrines the deterrence-based theory of punitive damages that formed an important basis of Justice Neely's opinion below, *amicus* most certainly disagrees with the contrary proposition advanced by TXO — that is, that the Constitution somehow forbids a State from basing its tort law on that theory. Just as the Constitution does not enact Mr. Spencer's *Social Statics*, *see Lochner v. New York*, 198 U.S. 45, 75 (1905) (Holmes, J., dissenting), neither does it embody TXO's peculiar brand of economics.

I. TXO undermined the method of contractual exchange, on which our free enterprise system rests, by pursuing an extortionate scheme to obtain a greater royalty interest through unlawful and fraudulent means, rather than through socially approved bargaining mechanisms. Punitive damages are necessary in a case like this in order to deter defendants from bypassing legitimate methods of contractual exchange. Defendants should be forced to negotiate in good faith for assets and should not be permitted to obtain them through blackmail or extortion. Awarding a plaintiff compensatory damages alone will not produce adequate deterrence, because a defendant's circumvention of the negotiation process (an extortionate "taking") in a "thin" market permits a defendant to capture all the gains from exchange that would have been divided between the parties under a scenario of negotiation. Punitive damages must be used to deter defendants from engaging in "contractual bypass" and similar strategic opportunism. The harms of such misconduct are not limited to plaintiffs who bring suit, but ripple throughout the economy as a whole and result in lost efficiencies and underutilization of resources. Punitive damages should be set at least equal to a defendant's expected gain. It is impossible to "overdeter" attempts at contractual bypass; the optimal level of such activity is zero.

II. Furthermore, the reason that respondent Alliance Resources Corp. did not suffer greater out-of-pocket losses in this case was that Alliance refused to succumb to TXO's extortion. But this does not provide an argument against punitive damages. Alliance should not be penalized for its vigilance or refusal to give in to TXO's threats; rather, TXO should be penalized for the profits it expected to realize and the social harm threatened by its misconduct. Thus, the absence of significant compensatory damages in this case *increases*, not *decreases*, the justification for punitive damages. Compensatory damages alone would fail to provide sufficient deterrence in this and many other intentional tort cases, and a State should be free to impose an ostensibly "disproportionate" amount of punitive damages in order to achieve adequate deterrence.

III. Punitive damages are also warranted in cases of intentional wrongdoing in order to remove a defendant's illicit gains from socially prohibited conduct. Compensatory damages alone do not ensure that this objective is met.

IV. TXO's concerns about the potential for legal error are misplaced. The possibility that judges will err in adjudicating intentional tort cases is small, and the limits of judicial competence in fact militate in *favor* of imposing punitive damages in instances of deliberate "contractual bypass" like the case at bar.

In sum, there is good reason not to impose any requirement that punitive damages bear a particular numerical relationship to compensatory damages. The traditional purpose of punitive damages is deterrence and punishment. If the expected gain or potential social harm of the defendants' conduct is large but compensatory damages are small — because the defendant's scheme is unsuccessful, for example — then punitive damages should be high. It is precisely in such situations, of course, that the arithmetic ratio between punitive and compensatory damages will be dramatic. Thus, the existence of a stark discrepancy between punitive damages and a plaintiff's out-of-pocket loss — like the alleged 526:1 ratio in the instant case — should not be a matter of constitutional concern.

Indeed, some of TXO's *amici* explicitly recognize that a plaintiff's out-of-pocket loss cannot provide the sole basis for computing the rationality of punitive damages. *See* Brief of the American Tort Reform Association, et al., as *Amici Curiae* in Support of Petitioner, at 15 ("where the injury is slight or only nominal, basing the penalty on the amount of compensatory damages is likely to be inadequate to provide appropriate punishment and deterrence"). Other *amici* acknowledge "the inherent arbitrariness" of any mathematical ratio requirement between compensatory and punitive damages. Brief of Arthur Andersen & Co., et al., as *Amici Curiae* in Support of Petitioner, at 13 (contending that "it would be sheer fortuity if punitive damages awards that were determined only by reference to some multiple of compensatory damages resulted in rational awards").

ARGUMENT

TXO is flatly wrong in suggesting that the only considerations germane to rational deterrence are the compensable harm suffered by the plaintiff and the probability of enforcement. There are at least three reasons that merely compensating a plaintiff for its loss will not guarantee adequate deterrence in a case like this one. A State should therefore be free to impose additional punishment in the form of punitive damages.

I. PUNITIVE DAMAGES ARE NEEDED TO PREVENT CALCULATED MISCONDUCT BY DEFENDANTS

A. Providing Compensatory Damages Alone Creates Perverse Incentives in "Thin" Markets

This case involves an attempt by TXO to subvert a system of contract. TXO used a fabricated cloud on respondents' title in an attempt to take a greater share of royalties than the parties had agreed to in voluntary negotiations. In the words of the West Virginia Supreme Court, TXO "knowingly and intentionally brought a frivolous declaratory judgment action against [respondents] to clear a purported cloud on the title. TXO's real intent, however, was to reduce the royalty payments under a 1,002.74 acre oil and gas lease." *TXO Production Corp. v. Alliance Resources Corp.*, 419 S.E.2d 870, 875 (W. Va. 1992). "[I]nstead of clearing the title directly by making the grantee of the quitclaim Tug Fork or approaching the [respondents] to discuss the title problem, TXO attempted to use the purported cloud as leverage for increasing its interest in the oil and gas rights." *Id.* at 877. In short, TXO committed the oil-and-gas analog of extortion.

The system of contract that TXO repudiated is the foundation of our economic order. In a world of rational economic actors, voluntary transactions produce outcomes that make both parties

better off and thus lead to increased social welfare.[1] A system of voluntary contractual exchange encourages mutual consensual decisions made on the basis of the parties' subjective valuations, producing more efficient outcomes for society overall than would a system operating by command. *See Harris v. Crowder*, 322 S.E.2d 854, 860 (W. Va. 1984) (Neely, J.) (noting benefits of free enterprise system).

Under a regime of purely compensatory damages, however, a defendant like TXO will have an incentive to engage in what economists term "strategic" behavior: if the defendant extorts or takes an asset from a plaintiff, and is required after the fact to pay only compensatory damages, the defendant will retain all the gains from exchange that would have been divided between the parties had they freely negotiated over the sale of the asset.[2] Damages that "compensate [a plaintiff] in a legal sense . . . are undercompensatory in a larger sense. They do not restore [the plaintiff's] preexisting opportunities for obtaining exchange values — opportunities for a share of any gains from exchange. The now impossible trade would have made [the plaintiff] more than whole." Haddock, McChesney, & Spiegel, *An Ordinary Economic Rationale for Extraordinary Legal Sanctions*, 78 Calif. L. Rev. 1, 16 (1990).

By awarding only compensatory damages, courts facilitate contractual bypass in "thin" markets like those for oil and gas

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[1] Such outcomes are called "Pareto efficient." *See* A. M. Polinsky, *An Introduction to Law and Economics* 7 n.4 (2d ed. 1989) ("A situation can be said to be Pareto efficient or Pareto optimal if there is no change from that situation that can make someone better off without making someone else worse off. Equivalently, if a situation is *not* efficient in this sense, then, by definition, someone *can* be made better off without making anyone else worse off.") (emphasis in original).

[2] This point is illustrated in an "Edgeworth box" analysis in Haddock, McChesney, & Spiegel, *An Ordinary Economic Rationale for Extraordinary Legal Sanctions*, 78 Calif. L. Rev. 1, 13-19 (1990), which is not reprinted here. *See also* Rose-Ackerman, *I'd Rather Be Liable Than You: A Note on Property Rules and Liability Rules*, 6 Int'l Rev. L. & Econ. 255, 259 (1986) (because defendants obtain all gains from trade if they are required to pay only compensatory damages, they will prefer paying damages over bargaining).

development, where assets are not homogeneous and for which there is no standard price quotation.[3] Each tract of land is unique, with its value dependent on a complex mix of information, risk aversion, technology, relative prices of other forms of energy, and other variables. All exchanges are negotiated, and it would be virtually impossible and extraordinarily expensive for a court to determine the content of a contractual bargain after the fact. Haddock, McChesney, & Spiegel, *supra*, at 21-22.

By imposing punitive damages at least equal to a defendant's expected gains, the court is relieved "of the valuation problems inherent in setting damages in a thin-market taking and also is able to protect [the plaintiff's] expectations concerning his investment." Toy, Note, *Statutory Punitive Damage Caps and the Profit Motive: An Economic Perspective*, 40 Emory L.J. 303, 310 (1991).[4] Thus, States must be permitted to set punitive damages according to defendants' *ex ante* expected gains. TXO's attempt to link the permissible limits on punitive awards to plaintiffs' out-of-pocket damages relies on incorrect assumptions:

> [I]f legal remedies always imposed ordinary damages, as in the standard liability model, incentives would exist for defendants to forego consensual exchange in favor of socially costly takings — "contractual bypass," so to speak. To discourage such takings, a legal remedy must leave a defendant

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[3] "A thin-market asset need not be rare or priceless; rather, the key attribute of a thin-market asset is that its owner is unable to find a ready replacement at a definite standard price." Toy, Note, *Statutory Punitive Damage Caps and the Profit Motive: An Economic Perspective*, 40 Emory L.J. 303, 309-10 (1991). Examples include land, skilled labor, and controlling blocks of corporate stock.

[4] *See also* R. Posner, *Economic Analysis of Law* 209-10 (4th ed. 1992); W. Landes & R. Posner, *The Economic Structure of Tort Law* 160-61 (1987); Landes & Posner, *An Economic Theory of Intentional Torts*, 1 Int'l Rev. L. & Econ. 127, 135 (1981); S. Shavell, *Economic Analysis of Accident Law* 148-49 (1987).

> who takes with no advantage vis-a-vis a defendant who bargains. . . . [T]he appropriate remedy for a violation of a property protection . . . is "punitive": it leaves [a defendant] worse off than negotiation would have. Merely compensatory damages are insufficient to discourage takings and encourage negotiation.

Haddock, McChesney, & Spiegel, *supra*, at 18-19.[5]

In this case, TXO's conduct was a classic example of strategic opportunism: it attempted to fabricate a claim of title, culminating in a quitclaim deed, in order to seek a judicial conferral of title upon it. TXO then attempted to use the threat of litigation and the concomitant cost of attorney's fees to browbeat the smaller Alliance into surrendering or reducing its right to the stream of royalties. The West Virginia Supreme Court found that this was not legitimate bargaining but was instead extortion, or "negotiation" at gunpoint. The Court opined that TXO was guilty of a "pattern of fraud, trickery and deceit." 419 S.E.2d at 890.

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[5] "Because the contractual bypass is a phenomenon that society wants to *eradicate*, it will not be enough to impose compensatory damages which merely make [the] plaintiff whole *ex post*. Punitive damages also must be imposed in an amount calculated to extract the profit [the defendant] expected to gain from his taking . . . . With such a rule, potential [defendants] will be deterred completely from bypassing the negotiating process, because the contractual bypass will never improve their situation and can only worsen it." Toy, *supra*, at 307-08. *See also* R. Posner, *Economic Analysis of Law* 220 (4th ed. 1992) ("[T]he proper sanction for a pure coercive transfer such as theft is something greater than the law's estimate of the victim's loss — the extra something being designed to confine transfers to the market whenever market-transaction costs are not prohibitive. We can be more precise: The extra something should be the difference between the victim's loss and the offender's gain, and then some."); Dobbs, *Ending Punishment in "Punitive" Damages: Deterrence-Measured Remedies*, 40 Ala. L. Rev. 831, 866, 874, 888 (1989) (proposing "gain-based" method of assessing punitive damages).

B. Providing Compensatory Damages Alone Leads to Social Deadweight Losses

The need for full deterrence is underscored by the fact that the harmful effects of such strategic behavior are not limited to the victims from whom assets are taken; instead, it diminishes the incentive of all potential market participants to invest in tradeable assets. "Furthermore, substitute investments less threatened by opportunistic takings will be enlarged, even where such investments are socially less valuable at the margin than the foregone alternatives."[6] In addition, potential victims and wrongdoers will expend resources in trying, respectively, to prevent and to effect the improper transfer of the good or asset in question — expenditures which are a deadweight social loss.[7]

Attempts at market-bypassing behavior weaken the system of consensual commercial exchange and private property ownership on which the free enterprise system rests.[8] A State has a great

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[6] Haddock, McChesney, and Spiegel, *supra*, at 16; *see also id.* at 17 ("[T]raders as a group will suffer if individuals can strategically substitute court-ordered compensation for negotiation. Liability rules make thin-market entitlements a sort of commons, so that gains that would otherwise be available from exchange instead will be dissipated by searches for and defense of takeable assets, and resources available for investment will be diverted toward less takeable uses."); Toy, *supra*, at 309 ("If [contractual] bypasses are not deterred, [plaintiffs] will be reluctant to invest their wealth and resources because their investment and accompanying expectations of future gain can be taken from them willfully and without adequate compensation. It therefore follows that voluntary transactions are important, not only for individual welfare, but also for society as a whole.").

[7] *See* R. Posner, *Economic Analysis of Law* 208 (4th ed. 1992); Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. Econ. J. 224, 230-31 (1967); McChesney, *Desperately Shunning Science?*, 71 B.U. L. Rev. 281, 284-86 (1991); Shavell, *Individual Precautions to Prevent Theft: Private versus Socially Optimal Behavior*, 11 Int'l Rev. L. & Econ. 123, 123-32 (1991); McChesney, *Boxed In: Economists and Benefits From Crime*, Int'l Rev. L. & Econ. (forthcoming 1993).

[8] *See* McChesney, *Deception, Trademark Infringement, and the Lanham Act: A Property-Rights Reconciliation*, 78 Va. L. Rev. 49, 54 (1992) ("Theft has no net social benefits — any gain to the thief is

interest in preventing what Professors Calabresi and Melamed call "property rules" from being converted into "liability rules."[9] That is, a State has a strong interest in preventing defendants from systematically bypassing the system of market exchange and private property rights by stealing assets, or attempting to steal them, rather than bargaining for them.[10] Indeed, Judge Posner

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essentially a transfer from the victim. At the same time, theft is costly. Resources that could be used to produce new goods and services are devoted instead to taking existing assets from others; owners of those assets must devote resources of their own to guard against theft. In addition, the possibility of having one's assets stolen diminishes the incentive to create them in the first place. . . . [Social control of theft] is not a problem of optimization at the margin. Rather, the law should seek the eradication of the valueless activity altogether."); *Punitive Damages: A Supporting Theory*, 40 Ala. L. Rev. 1227, 1234-35 (1989) ("Engaging in fraud . . . or actively misleading not only produces a need for compensation, it also undermines the foundation of the legal-economic structure in such a way that we cannot even guess the degree to which the system fails to operate efficiently. . . . [F]raud should frequently generate punitive awards.").

[9] *See* Calabresi and Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089, 1092 (1972) ("An entitlement is protected by a property rule to the extent that someone who wishes to remove the entitlement from its holder must buy it from him in a voluntary transaction in which the form of entitlement is agreed upon by the seller. . . . Whenever someone may destroy the initial entitlement if he is willing to pay an objectively determined value for it, an entitlement is protected by a liability rule.").

[10] *See* Calabresi and Melamed, *supra*, at 1126:

> Once we reach the conclusion that we will not simply have liability rules, but that often, even just on economic efficiency grounds, property rules are desirable, an answer to the question [of why a thief is not charged with the value of the stolen item] becomes clear. The thief not only harms the victim, he undermines the rules and distinctions of significance beyond the specific case. Thus even if in a given case we can be sure that the value of the item stolen was no more than X dollars, and even if the thief has been caught and is prepared to compensate, we would not be content simply to charge the thief X dollars. Since in the majority of cases we cannot be sure of the economic efficiency of the transfer by theft, we must add to each case an undefinable kicker which represents society's need to keep all property rules from being changed at will into liability rules.

has emphasized that deterring efforts at market bypass is one of the principal aims of criminal law, at whose intersection with tort law punitive damages lie.[11]

This principle is squarely applicable to the case before this Court. By threatening Alliance's property rights, TXO repudiated the system of private ownership that since the days of Blackstone has been recognized as providing necessary incentives

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Of course, in some instances a property interest *can* be taken and only "compensatory" damages paid. A primary example is state eminent domain proceedings, where such a rule is necessary to avoid holdout problems and strategic bargaining by landowners. In this case, however, such concerns are entirely absent; there is every indication that the title's purported ambiguity could have been resolved without extortion and blackmail by TXO. In any event, the "holdout" problem and other concerns are issues of policy, not of constitutional law, and should not be used to invalidate a State's system of punitive damages.

[11] Judge Posner has written that:

> The major function of criminal law in a capitalist society is to prevent people from bypassing the system of voluntary, compensated exchange — the "market," explicit or implicit — in situations where, because transaction costs are low, the market is a more efficient method of allocating resources than forced exchange. Market bypassing in such situations is inefficient — in the sense in which economists equate efficiency with wealth maximization — no matter how much utility it may confer in the offender. Much of this market bypassing cannot be deterred by tort law — that is, by privately enforced damage suits. The optimal damages that would be required for deterrence would so frequently exceed the offender's ability to pay that public enforcement and nonmonetary sanctions such as imprisonment are required.

An Economic Theory of the Criminal Law, 85 Colum. L. Rev. 1193, 1195 (1985). Of course, in the case of corporate defendants, "imprisonment" is a less practical alternative, and the use of civil punitive penalties to deter market bypassing is a sensible choice: "society could allow whomever the law was intended to protect to sue for punitive damages." *Id.* at 1201. "This means that the criminal law is designed primarily for the nonaffluent; the affluent are kept in line, for the most part, by tort law." *Id.* at 1204-05.

for investment in and efficient use of resources.[12] In concrete terms applicable to this case, oil and gas production would be retarded if owners, investors and producers were uncertain about rights of ownership or were obliged to avail themselves of expensive legal means to safeguard their rights and to ward off transgressors.[13] At the margin, it might be difficult to show a decrease in economic production directly attributable to individual acts of extortion and slander of title, but the same could be said for virtually all intentional torts and criminal episodes. Unless rules protecting lawful property rights are enforced categorically, and unless attempts at converting "property rules" into "liability rules" are punished, society as a whole will suffer.

C. Punitive Damages Should be Set According to a Defendant's Expected Gain, Not a Plaintiff's Out-of-Pocket Loss

The proper referent for the assessment of punitive damages is a defendant's expected gain, not a plaintiff's out-of-pocket loss. This point is conceded by Dean Griswold in a brief *amicus curiae* in support of TXO. He explains that punitive damages should be assessed to "[r]emov[e] the actual *or expected gain*,"

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[12] *See* 2 W. Blackstone, *Commentaries on the Laws of England* 4, 7 (1766); R. Posner, *Economic Analysis of Law* 32 (4th ed. 1992).

[13] *See* R. Hemingway, *The Law of Oil & Gas* 193 (1991) (noting, with respect to "slander of title affecting oil and gas interests," that "[a] disparaging statement about a particular property has a tendency to depreciate its market value through its effect upon the opinions of other people"); G. Morgenthaler, *Oil and Gas Title Examination* 65 (1982) ("[O]il and gas exploration and development is a very expensive business. The damages that could accrue from a failure of title to an oil and gas property developed in ignorance of a title defect are astronomical"); A. Anderson, *Fundamentals of the Petroleum Industry* 116 (1984) ("Any tract of land selected for drilling must be properly located and described. It is essential to know who owns precisely which few square feet, how that person came to have title to it, what is the history of the title, and precisely how the land is located with respect to other lands around it. . . . No oil company wants to sink a great deal of money into a well only to have its lease challenged later . . . .").

on the basis of "[t]he defendant's profits from his misconduct — or, in some cases, *the expected profits where the defendant fails to profit as expected*." Brief *Amici Curiae* for The American Council of Life Insurance, et al., at 15-16 (emphasis added); *see also id.* at 6 ("courts may evaluate the jury's award for excessiveness using the amount of a defendant's actual *or anticipated gain from his misdeeds*") (emphasis added).[14]

Thus, "the proper focus [for assessing punitive damages] is on the expected *ex ante* utility of defendants." Haddock, McChesney, and Spiegel, *supra*, at 18 n.54. Punitive damages should not be reduced simply because TXO's scheme did not succeed, any more than they should be reduced if the Blevins tract turned out to be less valuable than TXO believed at the time of its tortious conduct. Indeed, when actual gain is unexpectedly small, it will often be necessary to *increase* punitive damages, because compensatory damages will likely be small. *See* Galligan, *Augmented Awards: The Efficient Evolution of Punitive Damages*, 51 La. L. Rev. 3, 65 (1990). The proper calculation for punitive damages in cases where defendants do *not* achieve their intended objective is discussed further in Part II, *infra*, where we show that a State can rationally punish such cases as severely as it does cases in which defendants actually achieve their ends. At this juncture, however, we simply want to underscore a more basic point: whatever the precise magnitude of a punitive damages award, it must be set with reference to a defendant's expected gain, not to a plaintiff's out-of-pocket loss. TXO's brief ignores this fundamental principle.

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[14] The point is also conceded by former Deputy Solicitor General Frey in a brief filed by the American Tort Reform Association, et al., as *Amici Curiae* in Support of Petitioner: Among the factors relevant to the assessment of punitive damages is "the *anticipated* or actual gain to the defendant" (*id.* at 3) (emphasis added), alternatively phrased as "the actual or *potential gain* to the defendant." *Id.* at 12 (emphasis in original). "[T]he greater the *anticipated gain* from a tort, the greater the penalty needed to provide appropriate disincentives for its commission." *Id.* at 16 (emphasis added); *see also id.* ("the amount that the defendant gain *or reasonably could have expected to gain* from its misconduct") (emphasis added).

D. Concerns About "Overdeterrence" Are Misplaced

Some rights and assets (such as the entitlement to be free from breaches of contract or negligently caused accidents) are protected only by liability rules. A defendant who violates such a rule need pay only ordinary compensatory damages. But this case involves the intentional bypassing of contractual exchange through extortion and fraud — i.e., the conversion of a property rule into a liability rule. *See* Chapman & Trebilcock, *Punitive Damages: Divergence in Search of a Rationale*, 40 Ala. L. Rev. 741, 818 (1989) (noting that, under "established contract law," breaches of contract are not "absolutely normatively proscribed," as are crimes and intentional torts).

In this case, there should be no concern about "overdeterring" the kind of contractual bypass in which TXO engaged. Even if social welfare would be increased if a particular asset were in the hands of Firm A rather than Firm B, intentional predatory conduct by Firm A to acquire the asset is of no social value so long as the asset can be transferred through legitimate avenues of market exchange. Thus, attempts at contractual bypass "have *no* social value at any level: their optimal level is zero. To eradicate such activities, efficient law would . . . reduce to zero the expected gain available to the defendant from the injurious activity, leaving no incentive for him to attempt the activity in the first place." Haddock, McChesney, & Spiegel, *supra*, at 13; *see also Ackerman v. Schwartz*, 947 F.2d 841, 846-47 (7th Cir. 1991) (Easterbrook, J.) ("The optimal amount of fraud is zero."). "[A]n efficient legal system would try to eradicate property violations, not seek to optimize them." Haddock, McChesney, & Spiegel, *supra*, at 29.

II. PUNITIVE DAMAGES ARE NEEDED TO PUNISH AND DETER DANGEROUS ACTS THAT FORTUITOUSLY CAUSE LITTLE HARM IN THE INDIVIDUAL CASE

This case involves a scheme, carried through to completion, that — purely fortuitously — caused the plaintiff little out-of-pocket loss, although the scheme carried the potential for great social harm. TXO expected to obtain a greater share of royalties through its gambit, but Alliance refused to knuckle under to TXO's extortion. Alliance did not capitulate in the face of the quitclaim deed or the declaratory judgment action, and its rights were ultimately vindicated. Alliance's out-of-pocket losses came to only $19,000 in attorney's fees, although they could of course easily have been much greater. The West Virginia Supreme Court found that "[t]he type of *fraudulent* action *intentionally* undertaken by TXO in this case could potentially cause millions of dollars in damages to other victims." 419 S.E.2d at 889 (emphasis in original). The oil-and-gas market is a high-stakes business, *see, e.g., Pennzoil Co. v. Texaco, Inc.*, 481 U.S. 1 (1987), and it is entirely conceivable that TXO could profit by millions of dollars in the future using similar fraudulent schemes, just as it very nearly succeeded in capturing a substantial stream of royalties here.

Punitive damages are appropriate to deter such misconduct. Indeed, an excellent analogy was provided by one of TXO's *amici*, which recognized the appropriateness of punitive damages far in excess of a compensatory award "where a defendant has engaged in heinous conduct with huge potential for harm, but which resulted in little actual harm (*e.g.*, the defendant throws harmful acid at a person's face, but misses, causing only minimal clothing damage)." Brief of the American Automobile Manufacturers Ass'n, et al., at 23. This argument makes intuitive as well as economic sense.

First, extortionate behavior can itself create deadweight social losses even if the scheme is ultimately unsuccessful. To continue the acid-throwing analogy, such an episode may produce generalized societal fear, cause increased safety precautions, and lead persons to curtail their activities (*e.g.*, by refraining from

going out at night, or by not entering certain parts of a city) — even if the defendant in the acid-throwing incident is eventually apprehended.[15] In the same way, many of the negative effects of the kind of market-bypassing behavior for which punitive damages are awarded — decreased investment, increased precautions in protecting property, and so on — may persist even if attempts ultimately prove unsuccessful.

Second, punishing torts even where no harm is done increases deterrence. A defendant who knows that it will escape all but nominal punishment if its unlawful scheme does not cause the plaintiff appreciable harm has a greater incentive to embark on such a venture than a defendant who knows that it will be punished regardless of the outcome. A useful analogy is the punishment of attempts in criminal law, where punishing a criminal even if he is apprehended before he can complete the crime "increases the expected costs" of the crime to him: "[h]e cannot be certain that his attempt will succeed, and if it fails he will not merely forgo the gains from a successful [crime] but will incur additional (punishment) costs." R. Posner, *Economic Analysis of Law* 233 (4th ed. 1992). "Since Jeremy Bentham, and probably before, punishing attempts has been regarded as a means of supplementing deterrence of undesirable behavior."[16]

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[15] *See, e.g.*, Ellis, *Fairness and Efficiency in the Law of Punitive Damages*, 56 S. Cal. L. Rev. 1, 28 (1982); *Reality and Anxiety: Crime and the Fear of It*, N.Y. Times, Feb. 18, 1993, at A14 ("[F]or millions of Americans, the fear of crime may well be outpacing its growth. In increasing numbers, . . . Americans are arming themselves with an array of weapons, devices and gadgets intended to thwart criminals. . . . [M]illions of people are expressing a growing sense of vulnerability in ways large and small.").

[16] Shavell, *Deterrence and the Punishment of Attempts*, 19 J. Leg. Stud. 435, 437 (1990). "[P]unishment of attempts increases deterrence by raising the *probability* of imposing sanctions. Those who would shoot at another person will realize that they may be penalized if they miss as well as if they succeed; those contemplating engaging in theft will understand that they will suffer sanctions if they are apprehended trying to carry out theft as well as if they are caught red-handed with stolen goods. Punishing attempts thus increases deterrence by expanding the set of circumstances in which sanctions are imposed." *Id.* at 436.

Here, of course, TXO actually completed its scheme, failing to achieve its ultimate objective only because of Alliance's vigilance. But the analogy of punishing attempts nonetheless illustrates the role of punitive damages in enhancing deterrence in the present context.

States can choose from a number of possible rational approaches in addressing the problem of defendants who do not achieve their intended gain but are nonetheless detected and brought to justice. It is certainly rational to punish such defendants *as if* they had succeeded in realizing their illicit objective, as a simple numerical example illustrates. In general, the expected value of wrongdoing is equal to the monetary value the defendant will receive if the wrongdoing is successful[17] and if the defendant escapes detection,[18] multiplied by the *probability* that the defendant will both succeed and escape detection. For example, if a defendant expects an ultimate profit of $10 million, and the wrongdoing has an 80 percent probability of success and a 90 percent probability of avoiding detection and punishment, then the expected value is $7.2 million.[19] These two variables — success and detection — produce four kinds of defendants: (1) those whose wrongdoing succeeds and who go undetected ("successful undetected"); (2) those whose wrongdoing does not succeed but who are not detected ("unsuccessful undetected"); (3) those whose wrongdoing is successful but who are eventually detected ("successful detected"); and (4) those whose wrongdoing does not succeed and who are also detected ("unsuccessful detected").

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[17] By "success," we mean that the wrongdoing will, at least initially, achieve its intended effect.

[18] "Detection," quite apart from success, refers to the probability that the intended victim (or others) will discover the wrongdoing and act to enforce legal sanctions against it.

[19] This example is of course an oversimplification, since, for example, success may increase the probability of detection (i.e., the probabilities of success and detection may not be independent of one another), but the example suffices for present purposes.

Suppose that 50 percent of a given type of wrongdoing succeeds and 50 percent is detected. Then, if the payoff for an undetected, successful instance of such wrongdoing is $10 million, a defendant's *ex ante* expected value is $2.5 million. In order to deter both successful and unsuccessful wrongdoing, society must ensure that *all* defendants face an expected *ex ante* penalty of at least $2.5 million. Society can rationally choose from any of several approaches to arrive at this expected penalty of $2.5 million. For example, society could impose penalties only upon "successful detected" defendants; in order to deter all of this particular kind of wrongdoing, society would have to impose a penalty of at least $10 million on each such defendant (after first removing the $10 million in ill-gotten gains). Alternatively, however, society could elect simply to punish all defendants who are detected, regardless of whether they have been successful (after first removing, of course, the gains of those who happened to succeed). Under this approach, society could levy a punitive damages award of at least $5 million on both "successful detected" and "unsuccessful detected" defendants. The award on a per-defendant basis would be lower than if only "successful detected" defendants were punished, but the overall deterrent effect would be exactly the same because the expected penalty faced *ex ante* by all defendants is the same under both systems. In short, punishing all detected defendants, and punishing them without regard to their level of success, produces a rational system of deterrence.

Third, restricting plaintiffs' awards to compensatory damages and not punishing defendants' attempts that pose a great risk of harm (but in fact result in minimal losses) creates perverse incentives for defendants. Under such a regime, a defendant — even assuming that its gain is no more than a plaintiff's compensable loss — has the incentive to commit a tort where its expected gain (that is, the gross value discounted by the probability of detection and punishment) is greater than the defendant's net worth. If the defendant's attempt is unsuccessful, under the "compensatory only" regime it pays little in damages *whether or not it is detected*; if it succeeds and is not detected, it realizes the full value of the tort; if it succeeds but is detected,

its punishment can be no greater than its net worth. This string of possibilities will lead to a systematic and inefficient bias in favor of the tort's commission. In cases involving intentional torts with large potential payoffs, it is easy to imagine that the limits of defendants' net worth will be approached.[20] Awarding punitive damages in cases where an act fails to do significant harm to a plaintiff solves this problem.

For all these reasons, limiting TXO's punishment to Alliance's out-of-pocket loss would produce insufficient deterrence.[21] Indeed, "the sanction for an attempt need not be less than that for an identical act that results in harm." Shavell, *Deterrence and the Punishment of Attempts*, 19 J. Leg. Stud. 435, 437 (1990); *see also* Becker, *Criminal Attempts and the Theory of the Law of Crimes*, 3 Phil. & Pub. Aff. 262 (1974). The classic statement of this argument remains Professor Clarence Morris' trenchant observations of 62 years ago, which are worth quoting at length:

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[20] To continue the terminology of the previous section: if the probability of success for a certain class of intentional torts is 80 percent, the probability of detection only 10 percent, and the ultimate payoff $25 million, then the expected value of the wrongdoing is $18 million. But if courts can punish only "successful detected" defendants, then to achieve an expected penalty of $18 million on *all* defendants courts need to impose an actual penalty of $225 million on the 8 percent of all defendants who are both successful and detected. This sum might approach or exceed the net worth of many potential wrongdoers. Thus, under a "compensatory only" regime for "unsuccessful detected" defendants, the likelihood of inadequate deterrence would be quite real.

[21] *See, e.g.*, Mallor & Roberts, *Punitive Damages: Toward A Principled Approach*, 31 Hastings L.J. 639, 667 (1980) ("Punitive damages should bear a reasonable relationship to the harm that is *likely* to occur from the defendant's conduct, as well as to the harm that *actually* has occurred . . . . [T]he severity of harm, actual and threatened, is one factor that a court should consider in assessing punitive damages.") (emphasis added); Shavell, *Deterrence and the Punishment of Attempts*, 19 J. Leg. Stud. 435, 440 (1990) ("[I]t is desirable for the expected sanction for an act to equal the expected harm caused by the act . . . . [T]he expected sanction should be higher the higher the probability of harm or its magnitude is.").

The damage which the defendant *actually does* may have little or no relation to the size of the money judgment which would be the most effective admonition for the particular case. Of course, it is more important to forestall conduct which is *likely* to cause serious injury than it is to forestall conduct which is *likely* to cause only inconsequential damage. The probable result of a defendant's behavior is an important consideration in determining whether it is desirable to discourage such behavior in the future; the probable result is the measure of the "seriousness" of his wrong. *The actual result may have no bearing on this question. For example, the grossly negligent hunter may shoot into a crowd of people and only break a ten-dollar pair of eye glasses. The admonition meted out to him should be the same as though he had killed or injured someone.* . . . In other words, it is the known tendency of acts which makes it desirable to prevent them, *regardless of the particular results of any one commission.*

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> When an act with a vicious tendency happens to result in a small injury the "compensatory" damages are necessarily small. If it must follow that the punitive damages must also be small, the total verdict might be lenient where severity is desirable. . . . So *the ratio test seems to be an impediment in many cases, rather than a good legal tool. If it has any effect at all, it may limit punitive damage awards when they should be severe*, and result in heavy punitive damages when they should be lenient.

Morris, *Punitive Damages in Tort Cases*, 44 Harv. L. Rev. 1173, 1181-82 (1931) (emphases added). Justice Neely himself relied upon Professor Morris' analysis in his opinion for the Court in *Garnes v. Fleming Landfill, Inc.*, 413 S.E.2d 897 (W. Va. 1991):

> Punitive damages are necessary when compensatory damages are not large enough to convince a defendant or future defendants to take precautions against similar problems. For instance, a man wildly fires a gun into a crowd. By sheer chance, no one is injured and the only damage is to a $10 pair of glasses. A jury reasonably could find only $10 in compensatory damages, but thousands of dollars in punitive damages to teach a duty of care. We would allow a jury to impose substantial punitive damages in order to discourage future bad acts.

Id. at 901-902.

III. PUNITIVE DAMAGES ARE NEEDED TO OVERCOME A DEFENDANT'S "ILLICIT UTILITY"

A final reason that compensatory damages alone are inadequate is that the benefits obtained by a defendant from intentional wrongdoing can, as a normative matter, be recognized as illegitimate. Society can decide not to include such "illicit" gains as part of its calculus of whether to permit the defendant's activity. *See, e.g.*, S. Shavell, *Economic Analysis of Accident Law* 146-47 (1987). Punitive damages are necessary to combat intentional wrongdoing like the sort of misconduct that the West Virginia Supreme Court found to have occurred in this case, because such behavior is "far worse morally" than the mere negligence for which ordinary compensatory damages are typically awarded. R. Cooter & T. Ulen, *Law and Economics* 338 (1988).[22] This also provides another reason why concerns

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[22] *See also* Cooter, *Prices and Sanctions*, 84 Colum. L. Rev. 1525 n.27, 1549 n.58 (1985) ("illegitimate benefits or costs" should "receive no social weight"); Cooter, *Economic Analysis of Punitive Damages*, 56 S. Cal. L. Rev. 79, 89 (1982) ("the amount of money awarded in punitive damages will usually be large, because the illicit benefit or extraordinary cost of gross fault is large"); Coffee, *Paradigms Lost: The Blurring of the Criminal and Civil Law Models — And What Can Be Done About It*, 101 Yale L.J. 1875, 1883 n.28 (1992) ("Most theorists recognize that some

about overdeterrence are misplaced (*see* Part I-D, *supra*); if intentional torts produce no socially cognizable utility, reducing them does not make society worse off.

Thus, a State should not be barred by the due process clause from "overdeterring" deliberate misconduct on the asserted ground that the Constitution somehow *requires* the State to consider the utility derived by the defendant from the wrongdoing. That is, a State is not required to limit its punishment of thieves and other intentional wrongdoers to only those amounts "just sufficient to persuade [them] not to engage in the activity that the State condemns." Pet. Br. 28. A State should be free to decide, for example, that dangerous criminals or other intentional wrongdoers should be more than just slightly indifferent to embarking on a crime spree. Such a policy requires that damages awarded be greater than the actual loss suffered by the plaintiff or the actual gain realized by the defendant.

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forms of pleasure or utility may be illicit and should be subject to total deterrence"); Dau-Schmidt, *An Economic Analysis of the Criminal Law as Preference Shaping Policy*, 1990 Duke L.J. 1, 12-13; Lewin & Trumbull, *The Social Value of Crime?*, 10 Int'l Rev. L. & Econ. 271, 278 (1990) ("the exclusion of criminal gains [from the social calculus] is mandated by the fundamental premises underlying welfare economics and cost-benefit analysis"); R. Posner, *Economic Analysis of Law* 232 (4th ed. 1992) ("the utility of the criminal act to the criminal is to be ignored"); S.E. Rhoads, *The Economist's View of the World: Government, Markets, & Public Policy* 173 (1985); Schwartz, *Economics, Wealth Distribution, and Justice*, 1979 Wis. L. Rev. 799, 807 ("the rapist's pleasure, since it is fundamentally illicit, should not be given any weight at all"); *cf.* Ellis, *Fairness and Efficiency in the Law of Punitive Damages*, 56 S. Cal. L. Rev. 1, 77 (1982) (punitive damages can improve efficiency "where harm is deliberately caused and the satisfaction obtained by the actor is 'illicit'").

For an argument for the same conclusion from familiar economic principles, *see* McChesney, *Desperately Shunning Science?*, 71 B.U. L. Rev. 281, 284-86 (1991); McChesney, *Boxed In: Economists and Benefits From Crime*, Int'l Rev. L. & Econ. (forthcoming 1993).

IV. CONCERNS ABOUT LEGAL ERROR REGARDING INTENTIONAL TORTS ARE MISPLACED

Opponents of punitive damages argue that the possibility of legal error — *i.e.*, the risk that a defendant might be found liable for punitive damages by a jury and the verdict sustained by the trial court and by appellate courts, even though the defendant is in some sense "innocent" of such damages — should caution against the imposition of punitive damages. Although the risk of such a mistake is always present in the judicial system, it is relatively small in the context of punitive damages imposed for *intentional* torts. The effects of legal error are most commonly analyzed in negligence cases, where a court must assess a party's true level of care, a party's *momentary* level of care (for example, whether a driver experienced sudden glare, a sneeze, or a lapse of attention at the instant of an accident), and the level of due care required by the law in a particular circumstance.[23] These sources of uncertainly are less pronounced or absent altogether in intentional tort cases, where the legal level of care (i.e., complete abstinence from intentionally tortious activity) is defined in advance, and where a defendant faces "a pure either/or choice rather than a continuous range of choices with the optimum falling somewhere in the middle." Calfee & Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 Va. L. Rev. 965, 996 (1984).[24] "If there are

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[23] *See, e.g.*, S. Shavell, *Economic Analysis of Accident Law* 79-83 (1987); Johnston, *Punitive Liability: A New Paradigm of Efficiency in Tort Law*, 87 Colum. L. Rev. 1385, 1411-12 (1987).

[24] *See also* Landes & Posner, *An Economic Theory of Intentional Torts*, 1 Int'l Rev. L. & Econ. 127, 136 (1981) (probability of error is small in cases of intentional torts); Cooter, *Economic Analysis of Punitive Damages*, 56 S. Cal. L. Rev. 79, 79, (1982) ("The situation is analogous to the historical conflict between France and Germany in which armies did not cross the Rhine merely to occupy the far bank. . . . Unintentional fault usually involves a moderate degree of noncompliance, whereas intentional fault usually involves gross noncompliance. Intentional fault is gross because a person who deliberately exposes himself to liability crosses a threshold, after which aggravation of the fault is less costly.").

only two choices, and the choice of committing the act has been prohibited by society, then the other choice must be the social optimum. Defendants can either exactly comply with the optimum by not committing the act, or undercomply by committing the undesirable act, but overcompliance is impossible." Calfee & Craswell, *supra*, at 996 n.70; *see also* R. Posner, *Economic Analysis of Law* 209 (4th ed. 1992) (other reasons that overdeterrence is not a problem with intentional torts).

Furthermore, in intentional tort cases, punitive damages are available only if a plaintiff can prove not only that a defendant has committed an underlying offense, but also that the defendant has acted with the necessary malicious intent to make punitive damages appropriate. In this context, there is no reason *a priori* to expect a systematic bias in awards against defendants. If some defendants might be erroneously found liable for punitive damages, many others might be erroneously exonerated from liability.

More fundamentally, the mere possibility of judicial error is not an argument against punitive damages when a defendant has bypassed contractual systems of exchange, as is in the case here. Precisely *because* a court cannot know the subjective preferences of the parties and the content of the bargain they would have reached, it should impose punitive damages to deter defendants from circumventing contractual transactions. Court error, in other words, militates in *favor* of imposing punitive damages in instances of contractual bypass. *See* Haddock, McChesney, & Spiegel, *supra*, at 25.

CONCLUSION

The deterrence rationale articulated by the West Virginia Supreme Court was well founded in economic theory and human experience. TXO's attacks on that rationale reflect basic economic misconceptions and errors. The judgment should be affirmed.

Respectfully submitted,

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